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THE CITY OF SAN DIEGO

SUPERIOR COURT OF CALIFORNIA

COUNTY OF SAN DIEGO

THE CITY OF SAN DIEGO, Plaintiff, v. CALLAN ASSOCIATES, INC., GABRIEL ROEDER SMITH & COMPANY, AND DOES 1-100, Defendants.	Case No.: GIC 852419 **FIRST AMENDED COMPLAINT FOR DAMAGES AND INJUNCTIVE RELIEF FOR:** **(1) PROFESSIONAL NEGLIGENCE** **(2) INTENTIONAL FRAUD — AFFIRMATIVE MISREPRESENTATION** **(3) INTENTIONAL FRAUD — CONCEALMENT** **(4) UNFAIR COMPETITION** **DEMAND FOR JURY TRIAL**

Plaintiff The City of San Diego brings this complaint against defendants Callan Associates, Inc., Gabriel, Roeder, Smith & Co., and Does 1-100. San Diego seeks damages, recovery of the sums it has incurred as the employer contributor to the San Diego City Employees' Retirement System, and other relief resulting from the negligent and fraudulent conduct by each of the defendants named in this Complaint. San Diego alleges as follows:

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I. THE PARTIES AND JURISDICTION

1. Plaintiff The City of San Diego ("San Diego" or "The City") is a municipal corporation with all municipal powers, functions, rights, privileges, and immunities authorized by the Constitution and laws of the State of California. As a "charter city" under Article XI of the California Constitution, the City has the power to make and enforce all ordinances and regulations with respect to municipal affairs. Charter provisions have the effect of legislative enactments, and charter city ordinances and regulations regarding municipal affairs prevail over state laws covering the same issues.

2. Gabriel, Roeder Smith & Co. ("GRS") is a Michigan corporation having its principal place of business at 1 Towne Square, Suite 800, Southfield, Michigan 48076. GRS maintains an office at 9171 Towne Center, Suite 440, San Diego, California 92122. GRS does business in San Diego County and has sufficient contacts with this State to subject it to the personal jurisdiction of this Court.

3. Callan Associates, Inc. ("Callan") is a California corporation having its principal place of business at 101 California Street, Suite 3500, San Francisco, California 94111. Callan does business in San Diego County and has sufficient contacts with this State to subject it to the personal jurisdiction of this Court.

4. San Diego is ignorant of the true names and capacities, whether individual, corporate, associate, or otherwise, of defendants Does 1 through 100, inclusive. Upon information and belief, each fictitious defendant is in some way responsible for, participated in, or contributed to, the matters and things of which San Diego complains herein, and in some fashion, has legal responsibility therefore. When San Diego ascertains the exact identity of each such fictitious defendant and the nature of such fictitious defendant's responsibility for, participation in, and contribution to, the matters and things herein alleged, San Diego will seek to amend this complaint to set forth the same.

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II. VENUE

5. Venue is proper in San Diego County pursuant to section 395 of the California Code of Civil Procedure because all of the defendants do business in San Diego County and the facts which give rise to this litigation occurred in San Diego County.

III. GENERAL ALLEGATIONS

A. THE RELATIONSHIP OF THE CITY AND SDCERS

6. Section 141 of the City of San Diego City Charter (the "Charter") provides that the Council of the City is authorized and empowered by ordinance to establish a retirement system.

7. The San Diego City Employees' Retirement System ("SDCERS" or "the System") is a multiple-employer, defined benefit plan established in 1927 by the City to provide retirement, disability, death, and retiree health benefits to its members and their beneficiaries.

8. SDCERS is responsible for a) providing benefits to the retirement system participants and the beneficiaries, b) minimizing employer contributions thereto, and c) defraying reasonable expenses of administering the retirement system.

9. In furtherance of and to support these objectives, the City has empowered a Board of Administration (the "Board") to retain consultants to assist SDCERS. These consultants assist SDCERS and the Board in a) providing benefits to the retirement system participants and the beneficiaries, b) minimizing employer contributions thereto, and c) defraying reasonable expenses of administering the retirement system.

10. SDCERS' membership consists of employees of the three participating employers in the System: the City, the San Diego Unified Port District ("Port"), and the San Diego County Regional Airport Authority ("Airport"). Although SDCERS is a common administrative and investment agent for these employers, under Section 149 of the Charter, each respective employer adopts its own level of benefits and vesting schedule for its employees through its own plan. The funding status and required contributions are then determined separately for each employer plan.

11. The Plan for City employees ("city employee retirement fund") is by far the largest plan in SDCERS. As of June 30, 2004, SDCERS reported that the city employee retirement plan had valuation assets of $2.6 billion, the Port $141 million, and the Airport $16 million.

12. Pursuant to law, the City is responsible for making an annual contribution to the city employee retirement fund for the benefit of its employees and retired employees.

13. Section 143 of the Charter requires that: "The City shall contribute annually an amount substantially equal to that required of the employees for normal retirement allowances, as certified by [SDCERS'] actuary, but shall not be required to contribute in excess to that amount, except in the case of financial liabilities accruing under any new retirement plan or revised retirement plan because of past services of the employees. The mortality, services, experience or other table calculated by the actuary and the valuation determined by him and approved by the board shall be conclusive and final, and any retirement system established under this article shall be based thereon."

14. Pursuant to Section 145 of the Charter, all monies contributed by City employees or appropriated by the City Council to the retirement fund are placed in a special fund in the City Treasury called the "City Employees' Retirement Fund," a trust fund to be held and used only for the purpose of carrying out the provisions of Article IX of the Charter. Monies in the trust fund may not be merged with any other funds of the City.

15. Section 143 of the Charter prohibits any contracts or agreements that "delay[] full funding of City obligations to the system [SDCERS]."

16. Similarly, section 24.0801 of the San Diego Municipal Code ("Municipal Code") provides that the City must amortize within a period of 30 years "[a]ll deficiencies that occur due to the adoption of any Retirement Ordinances."

B. SDCERS BOARD OF ADMINISTRATION AND THE HIRING OF THIRD-PARTY CONSULTANTS

17. SDCERS, a trust fund, is administered by 13 trustees (the "Trustees") who together comprise the Board of Administration.

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18. Section 144 of the Charter provides that the City's retirement system is to be managed by a Board of Administration.

19. Prior to April 1, 2005, the Board consisted of: the City Manager; the City Auditor and Comptroller; the City Treasurer; three members of SDCERS elected by the general members; one member of SDCERS elected by the fire safety members; one member of SDCERS elected by the police safety members; one retired member of SDCERS elected by the retired membership; an officer of a local bank appointed by the City Council; and three other San Diego citizens appointed by the City Council. Each Board member served a six-year term on a staggered basis, with one term expiring each year.

20. Section 144 of the Charter was amended by San Diego voters in November 2004 so that beginning April 1, 2005, the Board's membership changed. In addition to one Trustee elected by the police safety membership, one Trustee elected by the fire safety membership, and one Trustee elected by the retired membership, the Board now consists of: seven Trustees appointed by the Mayor and confirmed by the City Council who are neither City employees, SDCERS participants, nor City union representatives; two Trustees elected by the general membership; and one City management employee appointed by the City Manager. These Trustees serve staggered terms of four years.

21. Beginning April 1, 2005, seven Trustees now constitute a quorum, and the concurring vote of seven Trustees is required for the Board to take any action. The seven Trustees appointed by the Mayor and confirmed by the City Council must have a college degree and at least 15 years of relevant professional experience.

22. Section 145 of the Charter creates the Retirement Fund, into which "[a]ll moneys contributed" by the City are placed. These funds are held in the City Treasury.

23. Section 144 of the Charter authorizes the Board to use some of these funds to hire third-party consultants to assist SDCERS.

24. SDCERS hired GRS and Callan as third-party consultants pursuant to this provision.

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25. Section 144 of the Charter also directs the Board, through its investment advisors and consultants, to invest, in the name of SDCERS, monies held in trust by the city employee retirement fund.

26. Section 144 of the Charter further provides that the Board shall be permitted to invest in additional classes or types of investments as are approved by resolution of the San Diego City Council.

27. Municipal Code section 24.0911 provides that the Board's officers and all employees of the Retirement System shall comply promptly with all lawful requests for information by the City Council, the City Manager, the City Attorney, or their designees.

C. DEFENDANT GABRIEL, ROEDER, SMITH & COMPANY ("GRS")

1. GRS' Relationship to SDCERS

28. GRS is a professional services firm that provides actuarial and consulting services to a variety of businesses.

29. GRS has a staff of more than 100 employees, with offices in California, Colorado, Florida, Illinois, Michigan, and Texas.

30. GRS promotes itself as "dedicated to providing current and accurate information of use to the benefits community." GRS also promotes itself as "dedicated to providing services that encourage sound financing, innovative benefit design, efficient administration, and effective communication of employee benefits."

31. Section 142 of the Charter requires that the Board retain a "competent actuary" with "expert or technical training."

32. GRS has been the actuary for SDCERS from the early 1990's and continues in that role presently.

33. In providing actuarial services to SDCERS during that time, Rick Roeder, a principal of GRS, has been the lead individual actuary.

34. Section 142 of the Charter also provides that the SDCERS actuary submit to the Board "a report of the cost of establishing a general retirement system for all employees of The City of San Diego."

35. Municipal Code section 24.1111 requires that the City's contribution to the retirement fund be an amount as determined by the SDCERS actuary pursuant to the annual actuarial evaluation performed by that actuary.

36. Section 143 of the Charter provides that the SDCERS actuary certify as sufficient the City's annual contribution to the retirement system.

37. As the principal actuary for SDCERS, for approximately the past 15 years, GRS has provided cost reports, set the amount that the City is required to contribute to SDCERS annually, and certified as sufficient, the City's annual contribution to the retirement system.

2. GRS' Negligent and Fraudulent Conduct

a. *GRS' Use of Corridor Funding Method for SDCERS*

38. Beginning as early as 1996, GRS made the decision to adopt what is commonly referred to as the "corridor funding" method for determining the funding level of the City's annual contribution to SDCERS.

39. The corridor funding method is a method of paying a certain rate into a retirement system as long as the funded ratio remains within a "corridor" range.

40. The impact of using a corridor funding method is that if the payment amount falls below the acceptable funding floor, additional and larger contributions will be necessary—often in a short amount of time—to bring the system to a stable level. The under-funding can result in a "net pension obligation," which is the difference between the annual cost of a pension plan and the employer's contributions to the plan.

41. The Governmental Accounting Standards Board ("GASB"), the national policy-making body which publishes accounting rules and standards for governmental accounting, has never approved a corridor funding methodology as an acceptable accounting method for the setting of employer contributions to a pension fund like SDCERS.

42. Since at least 1996 through 2004, GRS used the "corridor funding" method in order to set the City's employer contributions to SDCERS. This resulted in the City contributing to the system at fixed annual rates that were below the actuarially required contribution rate.

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43. GRS used the corridor funding methodology even though GASB repeatedly told GRS, in direct response to petitions from GRS, that GASB did not find "corridor funding" to be an appropriate accounting method for entities like SDCERS.

44. Indeed, from at least 1996 until 2001, GRS unsuccessfully petitioned the GASB to accept "corridor funding" as a sanctioned funding method for entities like SDCERS.

45. Upon information and belief, GRS' continuous effort to seek approval from GASB for the "corridor funding" method was done to conceal the fact that GRS was setting a contribution level for the City to SDCERS that was not actuarially sound.

46. Despite its knowledge that "corridor funding" was not a GASB-accepted funding method and that corridor funding understated the amount of the contribution that the City should have made to SDCERS using an appropriate, sanctioned actuarial method, GRS recommended to the Board on May 21, 1998, that corridor funding "is an excellent method for the City," and used the corridor funding method to set the City's contribution levels.

47. Upon information and belief, GRS further knowingly misstated on May 21, 1998, that: "In the long term, we believe corridor funding will be SUPERIOR to Projected Unit Credit [PUC] funding because higher reserves to satisfy fund commitments will ultimately be built up."

48. GRS knew that use of the "corridor funding" method was understating the City's contribution level and resulting in deficiencies in the city employee retirement fund.

49. GRS concealed material facts from the City concerning the impact of the corridor funding method on the city employee retirement fund.

50. Throughout the entire period of time that the corridor funding method has been in use, the City relied upon GRS' affirmative misrepresentations and half-truths that the corridor funding method was "SUPERIOR" and an "excellent method," and agreed to make annual contributions to SDCERS as set by GRS' calculations using the corridor funding method.

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51. Had the City known that the corridor funding method was not actuarially sound and would result in deficiencies in the pension fund system, it would have required GRS to use an actuarially sound method and would have made the required contributions on an actuarially sound basis.

52. The City was damaged by GRS' negligence, affirmative misrepresentations and concealment of material facts in connection with GRS' use of the corridor funding method, as this has led to a deficit in the city employee retirement fund for which the City will be required to make additional employer contributions now and in the future.

b. *GRS' Use of Different Amortization Periods*

53. In 1998, upon the recommendation of GRS, SDCERS adopted a 40-year amortization period for purposes of expensing and reporting its unfunded accrued actuarial liability ("UAAL").

54. Amortization is the gradual reduction and elimination of an interest-bearing liability by paying or allocating that liability through a series of installments over time, as opposed to a lump-sum payment or allocation. The UAAL is the amount of shortfall between the actuarial value of pension plan assets and the actuarial accrued liability of the pension plan.

55. Use of a longer amortization period obfuscates the gravity of the unfunded liability and understates the amount of contributions that are needed in the present to properly fund the unfunded liability.

56. Despite the fact that GRS knew that the use of a 40-year amortization period was not actuarially sound, GRS nonetheless set the contribution rates for the City for unfunded liabilities on the basis of the 40-year amortization period.

57. The City relied upon GRS' affirmative misrepresentations and half-truths that use of the 40-year amortization period was actuarially sound, and made annual contributions to SDCERS for unfunded liabilities as set by GRS' calculations that were based on the longer amortization period.

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58. Had the City known that use of the 40-year amortization period was not actuarially sound and would result in deficiencies in the city employee retirement fund, it would have required GRS to use an actuarially sound method and would have made the required contributions on an actuarially sound basis.

59. As a result of GRS' negligent and intentional conduct, the City was harmed and it will be required to make additional employer contributions now and in the future.

c. *GRS' Use of Actuarial "Smoothing" Method*

60. In FY 2001, the funded ratio of SDCERS was 89.9%, a decline from 97.3 % in FY 2000.

61. On September 19, 2002, GRS informed the Board of the 89.9% funding level.

62. Further declines in SDCERS' funded ratio were in part attributable to GRS' use of an actuarial "smoothing" method to calculate rates of return on fund assets.

63. Under GRS' actuarial "smoothing" method, GRS blended returns over a five-year period to conceal the full amount of loss in difficult years—for example, sharp declines in asset levels and resulting volatile contribution rates.

64. Throughout the entire period of time that GRS used this actuarial "smoothing" method, the City relied upon GRS' affirmative misrepresentations and half-truths that this methodology was actuarially sound, and agreed to make annual contributions to SDCERS as set by GRS' calculations using this methodology.

65. Upon information and belief, GRS used the actuarial "smoothing" method to conceal the true nature of the plummeting funding ratio of SDCERS.

66. Had the City known that use of the actuarial "smoothing" method was not actuarially sound and would result in deficiencies in the city employee retirement fund, it would have required GRS to use an actuarially sound method and would have made the required contributions on an actuarially sound basis.

67. As a result of GRS' conduct, the City was harmed and will be required to make additional employer contributions now and in the future.

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d. *GRS' Misconduct in Connection with MP I*

68. On or about June 21, 1996, SDCERS, through its Board, desired to enter into an employer contribution deferral contract, commonly referred to as Manager's Proposal I ("MP I"), with the City. The purpose of the MP I agreement was to increase the pension benefits to be paid to beneficiaries of SDCERS, specifically including certain members of the Board of SDCERS. As a result of MP I, the City contributed hundreds of millions of dollars less to the SDCERS pension trust fund than was legally required under the California Constitution, Charter section 143, and Municipal Code section 24.0801.

69. In connection with MP I, the San Diego City Council adopted ordinances that enhanced the retirement benefits of City employees and created millions of dollars of new pension benefits.

70. The new or enhanced benefits included a significant increase in the formula for calculating the basic pension benefit, as the multiplier for general members increased from 1.45% to 2.00% per creditable year of service; expansion of the "Purchase Service Credit;" and the agreement of the City to implement a Deferred Retirement Option Plan ("DROP"), which would permit employees who have reached their maximum benefit level to receive a lump sum payment upon retirement in exchange for forgoing accrual of all other benefits under SDCERS.

71. On or about June 21, 1996, a majority of SDCERS Trustees voted in favor of a motion to adopt MP I and/or to enter into a formal written agreement adopting MP I. The motion passed.

72. At the time of passage of MP I, GRS knew or had reason to know that MP I created a pension funding scheme that was not actuarially sound, and that would ultimately result in a substantial increase to the City's employer contributions to SDCERS.

73. GRS endorsed MP I in 1996, despite knowing that the funding level would drop below the trigger point of 82.3% for MP I in 5-6 years.

74. GRS concealed material facts about the changes to the retirement system resulting from MP I. Specifically, GRS concealed that the City had ceased contributing to SDCERS

on an actuarially sound basis. GRS also concealed that the reduced City contribution would have a negative impact on the investment value and funding ratio of SDCERS.

75. The City relied upon GRS' affirmative misrepresentations and half-truths in deciding to approve ordinances implementing MP I.

76. Had the City known that adoption of MP I was not actuarially sound and would result in deficiencies in the city employee retirement fund, it would have required GRS to use an actuarially sound method and would have made the required contributions on an actuarially sound basis.

77. Had the City known that voting the increased pension benefits of MP I would lead to deficiencies in the city employee retirement fund, it would not have approved the ordinances implementing MP I or it would have fully funded such benefits.

78. The actions of GRS concealed the funding shortfall. As a result of GRS' conduct, the City has been harmed and will be required to make additional employer contributions now and in the future.

e. *GRS' Misconduct in Connection with MP II*

79. On or about November 18, 2002, SDCERS, through its Board, decided to enter into a second employer contribution deferral contract with the City, commonly referred to as Manager's Proposal II ("MP II"). MP II was an expansion of the MP I scheme detailed above. The purpose of the MP II agreement was to substantially increase the pension benefits to be paid to beneficiaries of SDCERS, specifically including certain members of the Board of SDCERS. As a result of MP II, the City contributed hundreds of millions of dollars less to the SDCERS pension trust fund than was legally required under California Constitution, Charter section 143, and Municipal Code section 24.0801.

80. The new or enhanced benefits included an increase in the basic multiplier for retirement benefits for general employees to 2.5% at age 55, meaning that the cost of the basic retirement benefit would increase 25% over a two-year period; an agreement that the City Manager would propose to the Board that the Board transfer $25 million from surplus

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earnings into a reserve to fund the healthcare benefit in future years when earnings were insufficient to do so; and an agreement that changes in actuarial assumptions during the MP II period would not affect the City's contributions until FY 2010.

81. In connection with MP II, the San Diego City Council adopted ordinances that enhanced the retirement benefits of City employees and created millions of dollars of new pension benefits.

82. On November 5, 2002, GRS gave its written approval to the Board for adoption of MP II, stating that the Board's exercise of judgment was "reasonable."

83. However, GRS concealed material facts about the changes to the retirement system resulting from MP II. Specifically, GRS concealed that the City had ceased contributing to SDCERS on an actuarially sound basis. GRS also concealed that the reduced City contribution would have a negative impact on the investment value and funding ratio of SDCERS.

84. In addition, GRS intentionally and negligently misstated and misreported the annual actuarial valuation of SDCERS as of June 30, 2001. GRS reported that the City's funded ratio for SDCERS as of June 30, 2001 was 89.9%.

85. Upon information and belief, GRS knew that the City of San Diego's funded ratio for SDCERS was significantly less than 89.9%, but intentionally and negligently reported the erroneous higher valuation.

86. The funded ratio of SDCERS (after MP II had already been adopted) was reported as 77.3% as of June 30, 2002—a precipitous decline from the prior year's report of 89.9%.

87. The City relied upon GRS' affirmative misrepresentations and half-truths in deciding to approve ordinances implementing MP II.

88. Had the City known that adoption of MP II was not actuarially sound and would result in deficiencies in the city employee retirement fund, it would have required GRS to use an actuarially sound method and would have made the required contributions on an actuarially sound basis.

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89. Had the City known that voting the increased pension benefits of MP II would lead to deficiencies in the city employee retirement fund, it would not have approved the ordinances implementing MP II or it would have fully funded such benefits.

90. The actions of GRS concealed the funding shortfall. As a result of GRS' conduct, the City has been harmed and will be required to make additional employer contributions now and in the future.

f. *GRS' Fraudulent and Negligent Endorsement of the Financial Health of SDCERS*

91. On January 9, 1997, in its annual actuarial valuation for FY 1996, GRS stated: "Overall, we believe the City's Retirement System to be in sound condition in accordance with actuarial principles of level-cost financing."

92. However, for at least the reasons alleged throughout this Complaint, GRS knew that SDCERS was not in "sound condition" at the time it presented this conclusion to the Board.

93. Specifically, GRS concealed that the City had ceased contributing to SDCERS on an actuarially-determined basis, and was instead contributing on a basis of an agreement entered into between the Trustees and the City as described in MP I. GRS also concealed that the reduced City contribution would have a negative impact on the investment value and funding ratio of SDCERS.

94. On January 16, 1998, in its annual actuarial valuation for FY 1997, GRS stated: "Overall, we believe the City's Retirement System to be in sound condition in accordance with actuarial principles of level-cost financing."

95. However, for at least the reasons alleged throughout this Complaint, GRS knew that SDCERS was not in "sound condition" at the time it presented this conclusion to the Board.

96. Specifically, GRS concealed that the City had ceased contributing to SDCERS on an actuarially-determined basis, and was instead contributing on a basis of an agreement entered into between the Trustees and the City as described in MP I. GRS also concealed that the reduced City contribution would have a negative impact on the investment value and funding ratio of SDCERS.

97. On May 15, 1999, in its annual actuarial valuation for FY 1998, GRS stated: "Overall, we believe the City's Retirement System continues to be in sound condition in accordance with actuarial principles of level-cost financing."

98. However, for at least the reasons alleged throughout this Complaint, GRS knew that SDCERS was not in "sound condition" at the time it presented this conclusion to the Board.

99. Specifically, GRS concealed that the City had ceased contributing to SDCERS on an actuarially-determined basis, and was instead contributing on a basis of an agreement entered into between the Trustees and the City as described in MP I. GRS also concealed that the reduced City contribution would have a negative impact on the investment value and funding ratio of SDCERS.

100. On February 14, 2000, in its annual actuarial valuation for FY 1999, GRS stated: "Overall, we believe the City's Retirement System continues to be in sound condition in accordance with actuarial principles of level-cost financing."

101. However, for at least the reasons alleged throughout this Complaint, GRS knew that SDCERS was not in "sound condition" at the time it presented this conclusion to the Board.

102. Specifically, GRS concealed that the City had ceased contributing to SDCERS on an actuarially-determined basis, and was instead contributing on a basis of an agreement entered into between the Trustees and the City as described in MP I. GRS also concealed that the reduced City contribution would have a negative impact on the investment value and funding ratio of SDCERS.

103. On March 8, 2001, in its annual actuarial valuation for FY 2000, GRS stated: "Overall, we believe the City's Retirement System continues to be in sound condition in accordance with actuarial principles of level-cost financing."

104. However, for at least the reasons alleged throughout this Complaint, GRS knew that SDCERS was not in "sound condition" at the time it presented this conclusion to the Board.

105. Specifically, GRS concealed that the City had ceased contributing to SDCERS on an actuarially-determined basis, and was instead contributing on a basis of an agreement entered into between the Trustees and the City as described in MP I. GRS also concealed

that the reduced City contribution would have a negative impact on the investment value and funding ratio of SDCERS.

106. On February 12, 2002, in its annual actuarial valuation for FY 2001, GRS stated: "Overall, we believe the City's Retirement System continues to be in sound condition in accordance with actuarial principles of level-cost financing."

107. However, for at least the reasons alleged throughout this Complaint, GRS knew that SDCERS was not in "sound condition" at the time it presented this conclusion to the Board.

108. Specifically, GRS concealed that the City had ceased contributing to SDCERS on an actuarially-determined basis, and was instead contributing on a basis of an agreement entered into between the Trustees and the City as described in MP I. GRS also concealed that the reduced City contribution would have a negative impact on the investment value and funding ratio of SDCERS.

109. On January 9, 2003, in its annual actuarial valuation for FY 2002, GRS stated: "Overall, the financial condition of the retirement system is in adequate condition in accordance with actuarial principles of level-cost financing."

110. However, for at least the reasons alleged throughout this Complaint, GRS knew that SDCERS was not in "adequate condition" at the time it presented this conclusion to the Board.

111. For example, the funded ratio of SDCERS had dropped markedly to 77.3% for FY 2002, well below the trigger level for full repayment.

112. In addition, GRS concealed that the City had ceased contributing to SDCERS on an actuarially-determined basis, and was instead contributing on a basis of an agreement entered into between the Trustees and the City as described in MP I. GRS also concealed that the reduced City contribution would have a negative impact on the investment value and funding ratio of SDCERS.

113. The City relied upon GRS' repeated affirmative misrepresentations and half-truths in the annual actuarial valuations from FY 1996 to FY 2002 that the pension fund system was in "sound condition" or "adequate condition."

114. Had the City known the true nature of the financial health of SDCERS, the City would have required GRS to use an actuarially sound method and would have made the required contributions on an actuarially sound basis.

115. The actions of GRS also concealed the funding shortfall. As a result of GRS' conduct, the City has been harmed and will be required to make additional employer contributions now and in the future.

D. DEFENDANT CALLAN ASSOCIATES ("CALLAN")

1. <u>Callan's Relationship to SDCERS</u>

116. Callan Associates ("Callan") is a professional services firm that provides investment consulting services to a variety of pension funds, both public and corporate.

117. Callan promotes itself as "one of the oldest firms in institutional consulting, bringing more than a quarter-century of investment expertise to each client relationship."

118. Callan also notes in promotional materials that its sole aim is to "help our clients achieve their goals by providing unbiased, relevant information and advice."

119. Callan has stated that it represents over 150 investment management firms who are responsible for more than $7 trillion in assets, and range in size from less than $100 million to over $700 billion in assets under management.

120. Section 144 of the Charter provides that the Board shall have exclusive control of "investment of such fund or funds as may be established" in the retirement system.

121. Municipal Code section 24.0901 permits the Board to retain "independent investment counselors as needed to provide professional services to support the Board's investment responsibilities."

122. Callan was hired by the SDCERS Board in 1982 as SDCERS' investment consultant, pursuant to the City granting SDCERS the authority to hire consultants.

123. The original scope of Callan's services consisted of providing investment advice as the sole investment consultant for SDCERS.

124. Callan's original duties included: 1) providing investment performance measurement reviews and reports; 2) performing quarterly reviews of investment transactions; 3)

providing input on new programs, procedures and policies concerning other investment opportunities for the purpose of improving performance of the fund; and 4) performing all other services normally rendered by investment performance measurement consultants as the Board requested.

125. Callan's duties expanded over ensuing years. In 1985, Callan started performing asset manager searches for SDCERS.

126. In 1988, Callan took on the additional responsibility of providing attribution analysis on the performance of SDCERS' prior investment managers.

127. In 1989, Callan became the investment manager liaison for SDCERS (making it responsible for all fee negotiations, development and review of manager contracts and specific investment guidelines, and management of asset transitions among managers). At approximately the same time, Callan became responsible for manager peer group performance reporting; asset allocation and liability modeling; investment policy and guidelines statement development; and organizing and conducting educational seminars.

128. Callan also currently provides a full Asset Allocation and Liability Study each three to five years to evaluate the current allocation and target allocation for SDCERS.

129. Callan's current duties also include providing information and data that assists SDCERS in the analysis of alternative allocation schemes.

130. Callan is also charged with providing in-depth monitoring services for SDCERS as a whole, as well as for each individual investment manager.

131. In short, Callan is the primary investment manager of SDCERS and the principal overseer of investment decisions made for the benefit of the city employee retirement fund, and for the purpose of minimizing employer contributions to the fund.

2. Callan's Negligent Conduct

a. *Callan's Failure To Perform Competently as the Principal Investment Overseer of the City Employee Retirement Fund*

132. The manner in which the city employee retirement fund is invested is governed by Investment Policy Guidelines. These guidelines require that investment managers for

SDCERS rank in the top 40% of managers investing in a similar style during a three to five year period and rank in the top 40% of the total universe of equity managers during a three to five year period.

133. Callan was involved in the writing of these guidelines and is required to follow them when it recommends the selection of investment managers for the city employee retirement fund.

134. Upon information and belief, Callan recommended use of investment managers that did not rank in the top 40% of equity managers during a three to five year period. Many of these investment managers were hired to help manage the investments of the city employee retirement fund at Callan's urging.

135. For example, Callan referred Lincoln Capital Management ("Lincoln") to SDCERS despite Lincoln's poor performance record.

136. Upon information and belief, at the time Callan recommended Lincoln Capital Management, Callan knew that Lincoln Capital Management was ranked in the bottom 8% of its category in 2001 and in the bottom 12% of its category the previous three years.

137. Callan failed to recommend that SDCERS remove poor performers such as Lincoln from their positions working for SDCERS.

138. The City relied on Callan's recommendations and referrals when investing the funds held in the city employee retirement fund.

139. Callan concealed its negligence by failing to provide information when requested by SDCERS' Board members about these poor investment managers.

140. Because of Callan's negligence in selecting poor-performing investment managers to SDCERS, many of whom did not meet the criteria of the investment policy guidelines, the City has been harmed and will be required to make additional employer contributions to the city employee retirement fund now and in the future.

b. *Callan's Pay to Play Scheme*

141. In selecting which investment managers to refer to SDCERS, Callan employed what is commonly referred to as a "pay to play" scheme.

142. Upon information and belief, under Callan's "pay to play" scheme, Callan recommended that SDCERS employ investment managers from whom Callan received under-the-table fees that were not disclosed to the City.

143. Upon information and belief, these fees were paid to Callan under the guise that Callan was providing educational or consulting services to these investment managers.

144. Upon information and belief, in 2002, Callan's referrals to SDCERS of large-cap growth investment managers consisted entirely of candidates who had purchased educational and/or consulting services from Callan.

145. Upon information and belief, from an original pool of 339 candidates of large-cap growth managers, six candidates were recommended for hire by Callan.

146. Upon information and belief, the large-cap growth investment managers Callan recommended to SDCERS had paid as much as $500,000 to Callan for so-called educational and/or consulting services.

147. Upon information and belief, four of the six investment managers Callan recommended were also members of an organization set up by Callan called the Callan Institute. Upon information and belief, these four investment managers paid another $188,000 annually to be members of the Callan Institute.

148. Upon information and belief, Callan was asked by at least one SDCERS Board member in 2002 to provide information regarding the process by which these six large-cap growth managers were selected and Callan categorically refused to provide the information.

149. Callan further concealed the fact that its referrals were not based solely on Callan's professional assessment of investment managers' suitability for SDCERS' investment needs, but rather that its referrals were based on this "pay to play" scheme.

150. Had the City known that Callan was employing managers based on how much money Callan was receiving from these investment managers, rather than on their suitability as managers for the city employee retirement fund, the City would have required Callan to disclose its conflicts of interests and employ only unbiased methods for selecting and recommending managers.

151. The City relies on Callan as principal investment consultant to SDCERS to provide professional, unbiased and proper recommendations in stewardship of the city employee retirement fund.

152. The City has been harmed by Callan's failure to provide unconflicted advice, and the City will be required to make additional employer contributions to the city employee retirement fund now and in the future as a result of Callan's conduct.

c. *Brokerage Firm Benefits*

153. Callan has received financial or other benefits in exchange for encouraging SDCERS' investment managers to trade through selected brokerage firms.

154. Callan has failed to disclose its financial relationships with such brokerage firms and the benefits it has received from these relationships.

155. Callan's failure to disclose such relationships has harmed the City, as Callan's professional judgments have been compromised by Callan's own pecuniary self-interest.

156. Because of Callan's unlawful conduct, the City has been harmed and will be required to make additional employer contributions now and in the future.

FIRST CAUSE OF ACTION -
PROFESSIONAL NEGLIGENCE
(Against GRS and DOES)

157. The City incorporates by reference and realleges paragraphs 1 through 115 as though fully set forth herein.

158. As a professional actuarial firm, GRS had a duty to use the skill, prudence and diligence as other members of the actuarial profession commonly possess and exercise.

159. GRS breached that duty by, *inter alia*: a) using the "corridor funding" method; b) using a 40-year amortization period for unfunded liabilities; c) using the actuarial "smoothing" method; d) endorsing MP I and not disclosing its true impact; and e) endorsing MP II and not disclosing its true impact. GRS also breached its duty of care by failing to disclose the true financial health of SDCERS.

160. GRS' negligent conduct was a direct and proximate cause of the City's injury.

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161. As a result of GRS' negligent conduct, the City has suffered substantial loss and injury in an amount according to proof at trial.

162. The City recently discovered the facts alleged herein. After doing so, it promptly commenced an investigation of those facts and initiated this lawsuit. The City could not have reasonably learned of the magnitude of GRS' negligence earlier or otherwise have been put on notice of the negligence at an earlier date because GRS affirmatively misrepresented to and concealed from the City the true facts alleged herein. In addition, GRS' conduct has been ongoing and continues. Accordingly, any applicable statute of limitations period has been tolled and/or GRS is estopped from asserting a statute of limitations defense based on its affirmative misrepresentations or unlawful concealment.

SECOND CAUSE OF ACTION -
INTENTIONAL FRAUD - AFFIRMATIVE MISREPRESENTATION
(Against GRS and DOES)

163. The City incorporates by reference and realleges paragraphs 1 through 115 and 159 through 162 as though fully set forth herein.

164. GRS engaged in affirmative misrepresentations to the City. These misrepresentations included, *inter alia*, statements concerning the propriety and actuarial soundness of: a) using the "corridor funding" method; b) using a 40-year amortization period for unfunded liabilities; c) using the actuarial "smoothing" method; d) MP I; and e) MP II. GRS also made numerous affirmative misrepresentations about the financial health of SDCERS.

165. GRS knew that its representations to the City were false, and GRS intended to induce the City to rely upon those misrepresentations.

166. The City reasonably and actually relied on GRS' misrepresentations discussed more fully above.

167. As a direct and proximate result of GRS' actions, the City has suffered substantial loss and injury in an amount according to proof at trial.

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168. The City recently discovered the facts alleged herein. After doing so, it promptly commenced an investigation of those facts and initiated this lawsuit. The City could not have reasonably learned of the magnitude of GRS' fraud earlier or otherwise have been put on notice of the fraud at an earlier date because GRS affirmatively misrepresented to and concealed from the City the true facts alleged herein. In addition, GRS' conduct has been ongoing and continues. Accordingly, any applicable statute of limitations period has been tolled and/or GRS is estopped from asserting a statute of limitations defense based on its affirmative misrepresentations or unlawful concealment.

THIRD CAUSE OF ACTION - INTENTIONAL FRAUD - CONCEALMENT (Against GRS and DOES)

169. The City incorporates by reference and realleges paragraphs 1 through 115, 158 through 162, and 164 through 168 as though fully set forth herein.

170. GRS intentionally concealed material facts about the propriety and actuarial soundness of, *inter alia*: a) using the "corridor funding" method; b) using a 40-year amortization period for unfunded liabilities; c) using the actuarial "smoothing" method; d) MP I; and e) MP II. GRS also concealed numerous material facts about the financial health of SDCERS.

171. GRS was under a duty to tell the complete truth about the actuarial soundness of SDCERS, and not engage in obfuscation, half-truths, and omissions.

172. At the time of the concealment, GRS intended for the City to rely upon GRS' obfuscation, half-truths, and omissions. In concealing material facts, GRS intended to defraud the City.

173. The City reasonably and actually relied on GRS' obfuscation, half-truths, and omissions discussed more fully above.

174. Had the City known these concealed facts, it would have required GRS to use actuarially sound methods, it would made the required contributions on an actuarially sound basis, and it would not have agreed to enter into MP I or MP II.

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175. As a direct and proximate result of GRS' actions, the City has suffered substantial loss and injury in an amount according to proof at trial.

176. The City recently discovered the facts alleged herein. After doing so, it promptly commenced an investigation of those facts and initiated this lawsuit. The City could not have reasonably learned of the magnitude of GRS' fraud earlier or otherwise have been put on notice of the fraud at an earlier date because GRS affirmatively misrepresented to and concealed from the City the true facts alleged herein. In addition, GRS' conduct has been ongoing and continues. Accordingly, any applicable statute of limitations period has been tolled and/or GRS is estopped from asserting a statute of limitations defense based on its affirmative misrepresentations or unlawful concealment.

FOURTH CAUSE OF ACTION -
PROFESSIONAL NEGLIGENCE
(Against Callan and DOES)

177. The City incorporates by reference and realleges paragraphs 1 through 27 and 116 through 156 as though fully set forth herein.

178. As a professional investment consulting firm, Callan had a duty to use the skill, prudence and diligence as other members of the investment consulting profession commonly possess and exercise.

179. Callan breached that duty by, *inter alia*: a) referring poor-performing investment managers, such as Lincoln, to SDCERS, even though such investment managers did not meet SDCERS' investment needs; b) referring investment managers based on a "pay to play" system, rather than basing referrals solely on SDCERS' investment needs; c) failing to avoid conflicts of interest which could compromise the integrity of Callan's advice to SDCERS; and d) failing to fully disclose all conflicts of interest which could compromise the integrity of Callan's advice to SDCERS.

180. Callan's negligent conduct was a direct and proximate cause of the City's injury.

181. As a result of Callan's negligent conduct, the City has suffered substantial loss and injury in an amount according to proof at trial.

182. The City recently discovered the facts alleged herein. After doing so, it promptly 21-commenced an investigation of those facts and initiated this lawsuit. The City could not have reasonably learned of the magnitude of Callan's negligence earlier or otherwise have been put on notice of the negligence at an earlier date because Callan affirmatively misrepresented to and concealed from the City the true facts alleged herein. In addition, Callan's conduct has been ongoing and continues. Accordingly, any applicable statute of limitations period has been tolled and/or Callan is estopped from asserting a statute of limitations defense based on its affirmative misrepresentations or unlawful concealment.

FIFTH CAUSE OF ACTION -
UNFAIR COMPETITION
(California Business & Professions Code § 17200 *et seq.*)
(Against GRS and DOES)

183. The City incorporates by reference and realleges paragraphs 1 through 115, 158 through 162, 164 through 168, and 170 through 176 as though fully set forth herein.

184. GRS' fraudulent and negligent conduct, as alleged herein, constitutes unfair competition in violation of § 17200 *et seq.* of the Business and Professions Code.

185. As a direct and proximate result of GRS' wrongful conduct, the City has been damaged.

186. The City recently discovered the facts alleged herein. After doing so, it promptly commenced an investigation of those facts and initiated this lawsuit. The City could not have reasonably learned of the magnitude of GRS' unfair competition earlier or otherwise have been put on notice of the unfair competition at an earlier date because GRS affirmatively misrepresented to and concealed from the City the true facts alleged herein. In addition, GRS' conduct has been ongoing and continues. Accordingly, any applicable statute of limitations period has been tolled and/or GRS is estopped from asserting a statute of limitations defense based on its affirmative misrepresentations or unlawful concealment.

SIXTH CAUSE OF ACTION -
UNFAIR COMPETITION
(California Business & Professions Code § 17200 *et seq.*)
(Against Callan and DOES)

187. The City incorporates by reference and realleges paragraphs 1 through 27, 116 through 156, and 178 through 182 as though fully set forth herein.

188. Callan's negligent conduct, as alleged herein, constitutes unfair competition in violation of § 17200 *et seq.* of the Business and Professions Code.

189. As a direct and proximate result of Callan's wrongful conduct, the City has been damaged.

190. The City recently discovered the facts alleged herein. After doing so, it promptly commenced an investigation of those facts and initiated this lawsuit. The City could not have reasonably learned of the magnitude of Callan's unfair competition earlier or otherwise have been put on notice of the unfair competition at an earlier date because Callan affirmatively misrepresented to and concealed from the City the true facts alleged herein. In addition, Callan's conduct has been ongoing and continues. Accordingly, any applicable statute of limitations period has been tolled and/or Callan is estopped from asserting a statute of limitations defense based on its affirmative misrepresentations or unlawful concealment.

PRAYER FOR RELIEF

WHEREFORE, the City prays for judgment and damages against each defendant as follows:

1. For general damages according to proof;
2. For special damages according to proof;
3. For punitive damages for intentional fraud;
4. For a permanent injunction prohibiting the defendants from engaging further in the wrongful conduct alleged herein;
5. For disgorgement of profits, unjust enrichment and restitution;

6. For civil penalties pursuant to § 17200 *et seq.* of the Business and Professions Code;

7. For attorney's fees according to proof;

8. For the costs of suit herein; and

9. For such other and further relief as the court deems just and proper.

August 18, 2005

Respectfully submitted,

THE CITY OF SAN DIEGO

MICHAEL J. AGUIRRE, City Attorney

By
DON MCGRATH, Executive Assistant City Attorney

HELLER EHRMAN LLP

By *David E. Kleinfeld*
DAVID E. KLEINFELD

Attorneys for Plaintiff The City of San Diego

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DEMAND FOR JURY TRIAL

The City of San Diego demands a trial by jury on all counts of this Complaint.

August 18, 2005

Respectfully submitted,

THE CITY OF SAN DIEGO

MICHAEL J. AGUIRRE, City Attorney

By Don McGrath
DON MCGRATH, Executive Assistant City Attorney

HELLER EHRMAN LLP

By David E. Kleinfeld
DAVID E. KLEINFELD

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